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JAPAN · ECONOMIC · INSTITUTE

JEI

REPORT

NO. 42A November 14, 1986

JAPAN'S ROLE IN WORLD FINANCIAL MARKETS

Summary

The integration of world financial markets has progressed rapidly during the past decade as deregulation and technological progress have reduced the significance of national boundaries. The recycling of large trade surpluses and the financing needs of multinational corporations have also encouraged this trend. It is not surprising that Japan with its high saving rate and huge current account surpluses plays an important role in world financial markets. Japanese financial institutions' share of the international banking and securities markets has risen steadily in recent years, and as a result of the strong yen, more Japanese companies are seeking to lower costs through overseas production.

Japan's emergence as the world's leading exporter of capital gives it tremendous influence and power. Tokyo is fast becoming a major financial center along with New York and London, and international use of the yen in trade and investment as well as a reserve currency is increasing. The overseas expansion of Japanese financial institutions will accelerate financial liberalization at home. And Japan, now the world's largest creditor nation, will be called on to play a more central role in managing the debt problems of developing countries. Inevitably, though, the success of Japanese banks and securities firms abroad is creating a new area of international friction.

Japan's Rising Importance in World Finance

Like Britain and the United States before it, Japan's success in manufacturing has allowed it to become a financial power as well. As the free world's second-largest economic power, Japan accounted for about 10 percent of both global output and exports in 1985. Its trade surplus in 1986, predicted to reach $85 billion, will be equivalent to about 4.1 percent of the country's gross national product, a figure that exceeds the 3.8 percent recorded by Britain at the height of its empire and the 4 percent attained by the United States after World War II.

Its big external surpluses reflect the domestic saving-investment imbalance in Japan, where the private saving rate is considerably higher than in most other countries. During the 1970s these savings were largely absorbed by industry and the government (see Table 1). Business investment, however, has fallen since the first oil shock in 1973, and a fiscal austerity program aimed at lowering government deficits has been in effect since 1981. The result is a growing surplus of savings to be invested overseas. Japan's net long-term capital outflow totaled $64.5 billion in 1985, making it the largest net creditor nation with net foreign assets of $129.8 billion as of December 31 (see Table 2). Holdings of overseas securities account for much of the private sector's long-term assets (see Table 3).

Table 1: Japan's Saving and Investment

(percent of gross national product)

Years	Gross Domestic Investment	Gross Domestic Saving	Public Sector Deficit
1971-79 Average	33.5%	34.2%	-6.3%
1980	32.2	31.1	-6.7
1981	31.3	31.7	-7.3
1982	30.1	30.8	-6.9
1983	28.3	30.1	-6.8
1984	28.2	31.0	-5.8
1985	28.2	32.1	-3.6

Source: Bank for International Settlements, Fifty-Sixth Annual Report.

It should be noted that Japan only emerged as a major capital supplier in the past four years. From 1970 to 1980, its current account averaged a small surplus of $1.9 billion. At the end of 1981, Japan's net external assets totaled only $10.9 billion compared to $140.7 billion for the United States, then the largest net creditor nation. But Japan's large trade surpluses enabled it to overtake Britain, Saudi Arabia and the United States, which became a debtor nation in 1985 for the first time since World War I with net liabilities of $107.4 billion.

The JEI REPORT (ISSN 0744-6489) is published weekly for $40 per year by the Japan Economic Institute of America, 1000 Connecticut Avenue, N.W., Washington, D.C. 20036. Second class postage paid at Washington, D.C. POSTMASTERS: Send address changes to JEI, 1000 Connecticut Avenue, N.W., Washington, D.C. 20036.

Table 2: Japan's Net External Assets

(in millions of dollars)

End of Year	Private Sector	Government Sector	Total
1971	$-7,088	$16,861	$9,773
1972	-6,820	20,687	13,867
1973	-3,021	16,037	13,016
1974	-8,318	17,261	8,943
1975	-10,302	17,320	7,018
1976	-11,653	21,227	9,574
1977	-6,182	28,162	21,980
1978	-2,550	38,764	36,214
1979	850	27,927	28,777
1980	-16,659	28,193	11,534
1981	-18,537	29,455	10,918
1982	2,046	22,636	24,682
1983	11,928	25,331	37,259
1984	47,069	27,277	74,346
1985	104,450	25,371	129,821

Source: Bank of Japan, Balance of Payments Monthly, April 1986.

Table 3: Japan's External Assets and Liabilities

(in millions of dollars)

	Assets		Liabilities	
	End of 1984	End of 1985	End of 1984	End of 1985
Long-Term	$229,184	$301,297	$113,222	$122,328
Private Sector	191,946	264,458	83,738	91,776
Direct Investments	37,921	43,974	4,458	4,743
Trade Credits	22,824	23,603	24	131
Loans	40,601	46,870	1,266	1,211
Securities	87,578	145,748	77,081	84,847
Others	3,022	4,263	909	844
Government Sector	37,238	36,839	29,484	30,552
Trade Credits	1,189	1,062	103	84
Loans	24,491	23,293	29,381	30,468
Others	11,558	12,484	0	0
Short-Term	112,024	136,404	153,640	185,552
Private Sector	84,761	108,753	145,900	176,985
Monetary Movements	77,562	99,719	130,098	160,984
Others	7,199	9,034	15,802	16,001
Government Sector	27,263	27,651	7,740	8,567
Monetary Movements	27,261	27,650	3,590	4,557
Others	2	1	4,150	4,010
Total	341,208	437,701	266,862	307,880

Source: Bank of Japan, Balance of Payments Monthly, April 1986.

Domestic financial market deregulation has allowed Japan to develop into a major financial power. Prior to the first oil crisis, its capital markets operated in isolation and under tight regulations. A high degree of specialization among financial institutions and interest rate controls limited access to the markets and concentrated power in the Ministry of Finance and the central bank. Controls on international capital flows and foreign exchange transactions insulated Japan's financial structure from foreign influences. Although the regulations introduced inefficiencies into financial markets, the system was well suited to Japan's need for low-cost capital to increase productive capacity in the years after the war.

Economic events in the 1970s led to forces for change in the rigid financial structure. The two major oil price increases and the breakdown of the fixed exchange rate system resulted in higher rates of inflation, slower economic growth and volatile movements in the value of the yen. The increase in outstanding government debt, which rose from 6 percent of GNP in FY 1972 to 28.8 percent in FY 1980, also had a major impact. It resulted in the rapid development of Japan's primary and secondary bond markets and gave rise to pressures from the financial community for improvements in the efficiency of these markets.

Tokyo's development as a global financial center began in earnest with the Foreign Exchange Control Law of 1980, which made free international financial transactions the rule rather than the exception. The pace of financial liberalization was accelerated by the yen/dollar accord between Japan and the United States in May 1984. Under this agreement, intended to promote the internationalization of the yen, Tokyo took steps to deregulate the Euroyen market and gradually liberalize interest rates on large bank deposits. It also agreed to create a yen-denominated banker's acceptance market and to allow foreign banks to enter the trust banking business in Japan (see JEI Report No. 22B, June 8, 1984).

The Role Of Japanese Banks

Foreign medium- and long-term loans of $58 billion in 1985 enabled Japanese banks to overtake U.S. banks as the world's biggest lenders. They now account for one-fourth of international banking assets, well above this country's 18 percent share. The emergence of Japanese banks has occurred rather suddenly, considering that many only began overseas lending in 1980 when Tokyo eased controls on capital flows. With the realignment of exchange rates during the past 18 months, the competitive lineup has changed dramatically; seven of the ten largest banks in the world are now Japanese (see Table 4). They have also made important inroads in U.S. retail banking; for example, five of the top 11 banks in California are Japanese-owned.

This prominence is partially a result of a profit squeeze at home that sent Japanese banks scrambling overseas for new markets. Interest rate controls have been lifted on time deposits of Y300 million or more ($1.9 million at Y160=$1.00), and further deregulation is expected in the spring of 1987. As a result, roughly two-thirds of the new funds in commercial banks now come from instruments with market-determined interest rates compared with less than one-third five years ago. Banking sources say that liberalization may have already cost banks as much as one-tenth of their net income in the form of higher interest payments to depositors.

Table 4: World's Top Ten Commercial and Investment Banks, 1985

(in billions of dollars)

Commercial Banks	Assets*	Investment Banks	Equity*
Dai-Ichi Kangyo (Japan)	$190.0	Nomura Securities (Japan)	$3.4
Citicorp (U.S.A.)	173.6	Merrill Lynch (U.S.A.)	2.3
Fuji (Japan)	170.3	Nikko Securities (Japan)	2.1
Sumitomo (Japan)	164.9	Daiwa Securities (Japan)	2.0
Mitsubishi (Japan)	161.5	Salomon Brothers (U.S.A.)	1.7
Sanwa (Japan)	150.0	Yamaichi Securities (Japan)	1.6
Norinchukin (Japan)	136.9	Shearson Lehman Bros. (U.S.A.)	1.2
Industrial Bank of Japan	125.7	Prudential-Bache Securities (U.S.A.)	1.0
Banque Nationale de Paris (France)	123.1	Dean Witter Financial Services (U.S.A.)	0.9
Credit Agricole (France)	122.9	Goldman, Sachs (U.S.A.)	0.9

*Assets/equity as of March 31, 1986 for Japanese banks and December 31, 1985 for all others. The sharp appreciation of the yen has led to a significant reordering of the ranking.

Source: Fortune, October 27, 1986.

Weak demand for loans by the corporate sector, which has enjoyed three years of record profits, has also encouraged Japanese banks to expand overseas. And even when they do need to borrow, companies find that they can raise funds more easily in the Eurobond market. Overseas financing now accounts for almost half of the money raised by corporate Japan. Large firms have reduced their reliance on bank loans sharply -- from 80 percent in the first half of the 1970s to 43 percent in 1984 -- and this trend will continue as regulations governing corporate bond issues are eased. Even medium-sized firms, which currently rely almost entirely on bank loans, are likely to diversify their fund-raising activities.

Yet another strong motivation for overseas expansion is the opportunity to engage in the securities business -- an activity in which banks are limited in Japan. Most European countries generally permit universal banking. Although U.S. law continues to separate commercial and investment banking, the distinction is becoming increasingly blurred. The "securitization" of financial transactions has made it increasingly important for commercial banks to gain expertise in the area of securities. According to the Bank for International Settlements, net international bank lending fell from $165 billion in 1981 to $100 billion in 1985, while net bond financing rose from $32 billion to $125 billion. The importance of the securities business was further emphasized two years ago when Nomura Securities Co., Ltd. edged out Sumitomo Bank, Ltd. as the most profitable Japanese financial institution. The need to learn more about the securities market led to Sumitomo's recent proposal to invest $500 million in investment banker Goldman, Sachs & Co. (see JEI Report No. 41B, November 7, 1986).

Japanese banks, though, have several weaknesses that will slow their expanding world role. First, their profits are weak by international standards. Dai-Ichi Kangyo Bank, Ltd., for example, the largest in the world, ranked only sixteenth in net earnings. According to the Federation of Bankers Association of Japan, the assets-to-earnings ratio in Japan in 1984 was only 0.54 percent, well behind this country's 0.81 percent rate and West Germany's 1.06 percent. Second, Japanese banks are thinly capitalized, with a capital-to-assets ratio of only 3.4 percent in 1984 compared to 6 percent for U.S. banks and 6.6 percent for West German banks. In a precautionary move taken September 1, the Ministry of Finance now requires a bank to raise its capital before expanding foreign lending beyond a certain level.

Tokyo's offshore banking facility, scheduled to open December 1, will likely fall short of international and domestic expectations, reducing the expected benefits to Japanese banks. Bankers have criticized the government's plan to tax funds moving through the facility, arguing that it will limit volume. Yusuke Kashiwagi, chairman of the Bank of Tokyo, Ltd., predicts that annual turnover will be only $20 billion if taxes are imposed. The MOF anticipates that initial turnover could be as large as $70 to $80 billion and that it will equal Singapore's $180 billion volume within a short time.

Although most of what are now the international banking community's problem loans to third world countries had already been made by the time Japanese banks became major lenders, they, too, have been affected by the debt problems of developing countries. Banks in Japan hold 10 to 15 percent of all third world debt, with two-thirds of that exposure in Latin America. In addition, they have the biggest slice of the Philippines' debt on their books, as well as a quarter of Indonesia's and 15 percent of Mexico's. Thus far, Japanese banks have been forced to reschedule at least four-fifths of their loans to developing countries. Hard hit by falling oil prices and the appreciation of the yen, Indonesia is also likely to seek rescheduling of the yen component of its debt.

Not surprisingly, the success of Japanese banks has led to trade frictions, particularly in Britain, where they hold 23 percent of all banking assets. Competitors complain that Japanese banks are all too willing to sacrifice profits for market share by underpricing financial services. Banks in Europe and the United States also charge that Japan's lower capital-to-assets requirement gives their Japanese rivals an unfair cost advantage. This criticism has been echoed by some members of the Federal Reserve Board when examining applications by Japanese banks to take over California banks or set up new U.S. banking institutions -- for example, Mitsubishi Bank, Ltd.'s 1984 acquisition of BanCal Tri-State Corp., the holding company for the Bank of California (see JEI Report No. 42A, November 2, 1984) or the establishment of a New York City bank earlier this year by Mitsubishi Trust & Banking Corp.

Japan's Role in the World Securities Market

The internationalization of Japan's securities markets was set in motion in 1980 by the flow of petrodollars into Japanese stocks and bonds. It has continued over the past four years with the recycling of Japan's enormous trade surpluses. In 1981, Japanese purchases and sales of foreign bonds totaled only $13 billion, with net purchases of $5.8 billion. During the first six months

of 1986, however, two-way trading was nearly $1.2 trillion, and net purchases had jumped to $42.1 billion, accounting for 72.9 percent of Japan's long-term capital outlow during that period. Moreover, Japanese corporations have become important borrowers in international bond markets, with an eight-fold rise in the value of corporate bonds issued on overseas markets during the past 10 years.

These large capital flows have propelled Japanese investment banks to the front ranks, where they currently hold four of the top six positions despite a fairly static domestic market (see Table 4). In contrast to their overseas borrowing, the value of corporate bonds issued in the domestic market has been virtually flat in the past decade, discouraged by government regulations covering the issuing terms and fees.

Euroyen bonds (yen bonds issued outside Japan) have been the fastest growing segment of the Eurobond market and now rival the Deutsche mark as the second-largest sector. In the first half of 1986, $8 billion worth of Euroyen bonds were issued, up from $6.5 billion in all of 1985. Tokyo's decision to lower the minimum credit rating for borrowers and allow foreign banks to issue Euroyen bonds spurred the increased volume of lending, as did the rising yen, which encouraged investors to buy yen-denominated securities. This has helped Japanese securities firms, which handle about 95 percent of new Euroyen bond issues, become major international bond underwriters. Three of the top ten underwriters in the $137 billion-plus Eurobond market are Japanese.

A substantial share of surplus Japanese savings has been invested in U.S. assets, attracted by the size and liquidity of this country's capital markets. Net purchases of U.S. securities by Japanese investors in 1985 totaled $29.9 billion. Japanese investors also play a significant role in the U.S. Treasury securities market, although the financial press often exaggerates their importance. Japanese investors' net purchases of Treasury notes and bonds totaled $19.2 billion last year according to the Treasury Department, with purchases concentrated in longer maturity issues. This represents almost two-thirds of all foreign purchases of Treasury debt last year, and 12.8 percent of net new Treasury financing. Japan's top four securities firms have applied to become primary dealers of Treasury issues, but they could be beaten to the punch by the Industrial Bank of Japan, Ltd. Last month J. Henry Schroder Bank & Trust Co., an IBJ subsidiary, announced plans to buy Aubrey G. Lanston & Co., a primary dealer (see JEI Report No. 41B, November 7, 1986).

Japanese investors have begun to shift some of their capital into foreign equities, although net purchases remain small compared to bond purchases. Trading of overseas stocks rose from $1.6 billion in 1981 to nearly $10 billion last year with net purchases of $1 billion. During the first seven months of 1986, net purchases totaled $3.2 billion, largely in the United States. Some experts predict that Japan could overtake Britain by the end of the year as the largest foreign buyer of U.S. stocks.

There is also increased foreign interest in the Tokyo Stock Exchange, the second-largest in the world (see Table 5). The first six foreign securities firms purchased seats on the Tokyo Stock Exchange in November 1985. As of September 1986, the stock of 30 foreign companies was listed on the Tokyo Stock Exchange (including 13 banks), compared to 11 at the end of 1984. This number

is expected to continue rising, reflecting an easing of entry requirements and the eagerness of foreign firms to achieve a presence in Japan and participate in the 24-hour trading movement. With the new listings, there has been a surge in the average daily trading volume of foreign equities from 461,000 in 1985 to 1.2 million during the first eight months of this year.

Table 5: Value of Equities Traded on Principal Exchanges

(converted to U.S. dollars at exchange rates then in effect)

	December 31, 1974		June 30, 1986	
	Billions of dollars	Share	Billions of dollars	Share
United States	$510.4	56.2%	$2,291.1	44.3%
Japan	115.8	12.8	1,428.5	27.6
Britain	37.7	4.2	426.0	8.2
West Germany	45.3	5.0	200.6	3.9
Canada	44.0	4.8	158.0	3.1
France	26.3	2.9	118.8	2.3
Italy	12.2	1.3	100.5	1.9
Switzerland	13.1	1.4	97.8	1.9
Australia	17.6	1.9	64.4	1.2
Netherlands	11.3	1.2	62.3	1.2
Total*	892.4	100.0	5,154.4	100.0

*Includes exchanges not listed above.

Source: Morgan Stanley Capital International Perspective, 1986.

Japanese Foreign Direct Investment

In FY 1985 Japanese investors spent $12.2 billion on foreign direct investment ventures, 20 percent more than in the April 1984-March 1985 period. According to the Japan External Trade Organization, Japan's global direct investment outstanding ranked third at $37.9 billion at the end of 1984 (see Table 6). Despite rapid growth, the total as a share of Japan's GNP is a

Table 6: World Foreign Direct Investment, 1984

(stock values at end of 1984 in billion of U.S. dollars)

	Stock Value	Share of Total	Proportion of GNP	Per Capita*
United States	$233.4	42.5%	6.4%	$995
Britain	85.3	15.5	24.3	1,513
Japan	37.9	6.9	3.1	316
West Germany	36.6	6.7	6.9	598
Canada	31.3	5.7	10.6	1,146
Netherlands	31.2	5.7	28.2	2,143
All others (estimated)	93.3	17.0	---	---
Total (estimated)	549.0	100.0	---	---

Source: Japan External Trade Organization

Table 7: Japan's Foreign Direct Investment by Country, FY 1981-FY 1985

(in millions of dollars)

	FY 1981	FY 1982	FY 1983	FY 1984	FY 1985	Cumulative March 31, 1986
United States	$2,354	$2,738	$2,565	$3,360	$5,395	$25,290
Canada	167	167	136	184	100	1,675
North America	2,522	2,905	2,701	3,544	5,495	26,965
Panama	614	722	1,223	1,671	1,533	6,400
Brazil	316	322	410	318	314	4,587
Mexico	82	143	121	56	101	1,330
Peru	4	185	0	6	10	696
Bermuda	32	5	14	29	148	601
Latin America	1,181	1,503	1,878	2,290	2,616	15,636
Indonesia	2,434	410	374	374	408	8,423
Hong Kong	329	400	563	412	131	2,931
Singapore	266	180	322	225	339	2,269
Korea	73	103	129	107	134	1,683
Malaysia	31	83	140	142	79	1,125
Philippines	72	34	65	46	61	892
Taiwan	54	55	103	65	114	761
Thailand	31	94	72	119	48	760
Asia	3,338	1,384	1,847	1,628	1,435	19,463
Kuwait	50	41	66	55	34	1,268
Iran	0	0	1	0	0	1,003
Middle East	96	124	175	273	45	2,972
United Kingdom	110	176	153	318	375	3,141
Netherlands	138	73	113	452	613	1,687
West Germany	116	194	117	245	172	1,343
Luxembourg	104	127	265	315	300	1,216
France	54	102	93	117	67	819
Belgium	107	64	126	71	84	743
Switzerland	67	79	37	229	60	663
Spain	39	19	52	140	91	514
Europe	798	876	990	1,937	1,930	11,002
Liberia	466	434	323	281	159	2,455
Africa	573	489	364	326	172	3,369
Australia	348	370	166	105	468	3,621
Oceania	424	421	191	157	525	4,242
Total	8,931	7,703	8,145	10,155	12,217	83,649

Source: Ministry of Finance

Table 8: Japan's Foreign Direct Investment by Industry, FY 1981-FY 1985

(in millions of dollars)

	FY 1981	FY 1982	FY 1983	FY 1984	FY 1985	Cumulative March 31, 1986
Manufacturing Sector	$2,305	$2,076	$2,588	$2,505	$2,352	$24,400
Food Products	142	78	77	118	90	1,091
Textiles	91	67	174	85	28	2,083
Wood Products	65	76	91	115	15	1,120
Chemicals	228	322	450	223	133	3,982
Metals	521	468	479	718	385	5,190
Nonelectric Machinery	207	164	169	185	352	1,971
Electric Machinery	475	267	502	409	513	3,747
Transport Equipment	406	439	486	437	627	3,373
Other	169	195	160	215	208	1,841
Nonmanufacturing Sector	6,516	5,478	5,357	7,429	9,536	56,337
Agriculture/ Forestry	75	40	18	26	12	780
Fisheries	36	22	17	24	42	442
Mining	2,534	685	382	484	598	11,756
Construction	96	44	55	112	94	798
Trade/Sales	1,174	1,899	1,164	1,482	1,550	12,677
Banking/Finance/ Insurance	843	533	1,167	2,085	3,805	10,859
Services	623	702	622	681	665	4,686
Transportation	722	924	1,363	1,651	1,240	5,900
Real Estate	167	354	375	430	1,207	2,533
Other	246	276	193	454	322	5,906
Branch Offices	110	149	200	221	329	2,318
Real Estate Transactions*	---	---	---	---	---	595
Total	8,931	7,703	8,145	10,155	12,217	83,649

*Overseas real estate transactions have been excluded from Japan's foreign direct investment data since December 1, 1980 because of changes in the Foreign Exchange and Foreign Trade Control Law.

Source: Ministry of Finance

relatively low 3.1 percent. Moreover, Japan's 6.9 percent share of the world total is small compared to the United States and Britain. Both indicators suggest considerable room for expansion.

There has been a marked shift in the pattern of Japan's direct foreign investment from the developing countries to the industrial nations, as shown by a rise in their share of cumulative investment from 27 percent at the end of FY 1974 to 50 percent by March 31, 1986 (see Table 7). Japan's direct investment in the 1970s centered on resource development and labor-intensive production, but in the 1980s turned to manufacturing in the industrial countries. Japanese investors are also moving aggressively into such areas as banking, finance, and insurance and real estate (see Table 8). The need to lower production costs in the face of the strong yen, though, will probably result in more investment in production facilities in developing countries.

Investment in the United States alone accounted for 44 percent of the total in FY 1985, while the amount invested in Asia and the Middle East declined. Japan has become a major investor in this country during the past few years (see Tables 9 and 10). Its investment position grew from $7.7 billion at year-end 1980 (7 percent of the U.S. total) to $19.1 billion at the end of 1985 (more than 10 percent). Real estate purchases by Japanese investors are increasingly significant; industry sources estimate that total investments in this country in this sector will rise from $1.5 billion last year to $3 to $5 billion in 1986.

Table 9: Foreign Direct Investment Position in the United States, Year-End 1981-1985

(in millions of dollars)

	1981	1982	1983	1984	1985
United Kingdom	$18,585	$28,447	$32,152	$38,387	$43,766
Netherlands	26,824	26,191	29,182	33,728	36,124
Japan	7,697	9,677	11,336	16,044	19,116
Canada	12,116	11,708	11,434	15,286	16,678
West Germany	9,459	9,850	10,845	12,330	14,417
Switzerland	5,474	6,378	7,464	8,146	11,040
Netherlands Antilles	8,232	9,190	9,948	10,935	10,603
France	5,876	5,708	5,726	6,591	6,295
OPEC Countries	3,336	4,045	4,039	4,892	4,560
Total	108,714	124,677	137,061	164,583	182,951
of which:					
Mining	2,152	1,876	1,928	3,920	4,070
Petroleum	15,246	17,660	18,209	25,400	28,123
Manufacturing	40,533	44,065	47,665	51,802	60,798
Wholesale Trade	16,012	18,397	21,031	24,455	27,514
Retail Trade	4,525	5,207	5,482	6,764	6,698
Banking	6,553	7,846	8,697	10,326	11,503
Finance	1,109	2,159	2,269	5,633	4,708
Insurance	7,086	7,928	8,665	8,922	11,069
Real Estate	8,964	11,520	14,636	17,761	18,557
Other	6,533	8,019	8,478	9,599	9,912

Source: Department of Commerce

Table 10: Japan's Foreign Direct Investment Position in the United States, Year-End 1981-1985

(in millions of dollars)

	1981	1982	1983	1984	1985
Total	$7,697	$9,677	$11,336	$16,044	$19,116
Mining	4	4	*	7	7
Petroleum	-78	113	-408	-88	31
Manufacturing	1,321	1,624	1,605	2,460	2,621
Food Products	165	182	186	186	149
Chemicals	249	252	283	252	267
Metals	121	117	140	541	575
Machinery	415	423	466	628	624
Other	372	649	530	853	1,005
Wholesale Trade	4,984	6,126	7,823	9,689	11,572
Retail Trade	67	151	234	252	250
Banking	1,180	1,325	1,384	1,853	2,176
Finance	*	-570	*	513	710
Insurance	*	169	182	138	122
Real Estate	305	396	515	744	1,054
Other	350	339	430	475	575

*Suppressed to avoid disclosure of data on individual companies.

Source: Department of Commerce

The threat of protectionism and the need to remain competitive in the face of the high yen will accelerate Japan's foreign investment in the years ahead. Calculated at an exchange rate of Y160=$1.00, the average Japanese manufacturing wage is the highest in the world -- $10.42 versus $9.52 in the United States -- according to estimates by the Industrial Bank of Japan. The Maekawa Report, released last April by an advisory committee to the prime minister, called for policies to double the outstanding balance of direct investment abroad over the next seven years. And the Economic Planning Agency projects that as a result of the yen's appreciation, 20 percent of the country's manufacturing output will take place abroad by the turn of the century, compared with the current level of only 2.4 percent.

Implications of Japan's Emerging Role

Japanese long-term net capital outflow, which totaled $86.4 billion in the first nine months of 1986, nearly double what it was for the same period a year earlier, is likely to remain strong in coming years. Individuals are shifting their funds from low-interest bank and postal savings deposits to higher-yielding securities, with a growing proportion invested in foreign assets. Japanese companies are relying on financial investments to soften the blow of lower export earnings. Recent regulatory changes insure that foreign investment will remain large. In September, for example, the limit on the

ratio of foreign currency assets held by insurance companies was raised to 35 percent from the 25 percent ceiling set earlier in 1986. Foreign assets now account for about 18 percent of their total assets of Y53.9 trillion ($336.9 billion). And in April, the Posts and Telecommunications Ministry decided to end its limits on foreign securities purchases by the postal insurance fund, which had total assets of Y28 trillion ($175 billion) as of early 1986.

It is likely, therefore, that Japan's external assets in 1995 will reach the $1 trillion mark predicted by the Nomura Research Institute. As was true in Britain in the 19th century and the United States following World War II, the nation that is the chief supplier of capital to the world acquires tremendous power and influence. Although Japanese financial institutions will try to diversify away from dollar assets, a substantial share of Japanese funds will continue to be attracted to the highly developed capital markets of the United States. This is contributing to what Alan Greenspan, former chairman of the Council of Economic Advisers, termed "one of the most extraordinary integrations in the history of the world as a result of mutual dependence."

Inevitably, Japan's emergence as a major financial power has led to frictions with other countries. Because of their focus on market share rather than profits, Japanese firms have been accused of underpricing financial services. Last month Washington formally requested that Tokyo quickly permit American banks to enter the securities business in Japan. Moreover, 38 members of Congress urged the New York Federal Reserve Bank last year to reject the applications of the major Japanese securities firms to serve as primary dealers of Treasury securities until U.S. firms are accorded reciprocal treatment in Japan. And growing Japanese foreign direct investment is leading to fears, similar to those concerning Arab investors in the 1970s, that Japan will "own the world."

Japan is also playing a growing role in managing the developing countries' debt problems. Last month, Tokyo offered to lend $3.6 billion to the International Monetary Fund and increase its contribution to the International Development Agency (see JEI Report No. 37B, October 10, 1986). As commercial banks pull back from lending to developing countries, the Japanese government is being asked to make a greater contribution in this area. Recently, the Philippines requested a Y260 billion ($1.6 billion) loan. Some business leaders in both Japan and the United States have urged Tokyo to adopt a major aid initiative, similar to this country's Marshall Plan for postwar Europe.

International use of the yen for trade and investment and as a reserve currency will increase as a result of Japan's financial strength. At present, yen-denominated trade accounts for only 1 percent of total world trade. Only 3 percent of Japan's imports are valued in yen, while about 40 percent of the purchases made by West Germany, Britain and France are denominated in local currencies. Although the share of the yen in global official foreign exchange reserves went from 2 percent in 1976 to 5.2 percent in 1984, it is still small relative to the dollar's 65.1 percent share and the West German mark's 12 percent share. And only 7.4 percent of international bond issues in 1985 were denominated in yen, compared to 59.3 percent denominated in dollars. According to a Nomura Research Institute survey of financial experts, a majority believe that international use of the yen in 10 years will be comparable to the current level of the mark.

Japan's role in the increasingly integrated world financial markets will continue to accelerate the liberalization of its domestic market. Under present banking regulations, the activities of commercial banks and securities firms are separated in order to prevent financial institutions from being exposed to the same company as both a lender and an equity investor. These rules are also intended to limit the power of Japanese banks over the manufacturing sector. But there is increasing pressure to end this distinction now that both Japanese banks and securities firms have been doing more of each others' kind of business in overseas markets. Moreover, Japanese banks complain that it is unfair to allow subsidiaries of foreign banks to engage in the securities business in Japan while they are excluded. Domestic banks have already begun trading government bonds and some experts think that the distinction will be abolished in the next few years.

Another result of Japan's emergence in world financial markets is Tokyo's growing importance as a major financial center increasingly linked to New York and London in a tripartite axis of global finance. Foreign financial firms have located in Tokyo to compete with Japanese firms and to tap surplus Japanese savings. The chairman of the Bank of Tokyo estimates that the American financial market is still the largest at $7.1 trillion, followed by Japan's $2.2 trillion and Britain's at $1.6 trillion. But Japan's expansion between 1970 and 1985 was a high 18.3 percent, with Britain next at 14.5 percent and the United States third at 8.8 percent.

According to a Nomura Research Institute survey, Tokyo compares favorably with New York and London in three areas important for an international financial center: a well-developed telecommunications network, market size and political stability. But the survey says that Tokyo is still handicapped by regulations governing foreign exchange transactions and capital movements and by a lack of personnel experienced in international finance. To enhance Tokyo's global role, it is important that internationally accepted trading rules and practices be adopted. This, in turn, will require the government to sacrifice some of its control over the financial market if Tokyo is to achieve its full potential as an international financial center.

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The views expressed in this report are those of the author and do not necessarily represent those of the Japan Economic Institute.